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FEDERAL COMMUNICATIONS COMMISSION
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National Cable Television Association

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August 3, 1993

Mr. William Caton
Acting Secretary
Federal Communications Commission
1919 M Street, NW
Room 222
Washington, DC 20554

Re: Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992: Rate Regulation
<u>MM Docket No. 92-266</u>

Dear Mr. Caton:

I have just learned from Ms. Kathleen Ham, an attorney in the Mass Media Bureau, that a page was missing from the copies of our Opposition to Petitions for Reconsideration in the above captioned proceeding, which we filed on July 21, 1993. I have today delivered ten copies of the missing page to Ms. Ham, and I am submitting for filing with the Commission ten additional copies of our Opposition, with the missing page 9 included.

If there are any questions regarding this matter, please let me know. Thank you very much for your assistance.

Very truly yours,

Michael S. Schooler

Enclosures

MSS:ldh

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, DC 20554

In the Matter of	)	
	)	
Implementation of Sections of the Cable Television Consumer Protection and Competition Act of 1992	)	MM Docket No. 92-266
	)	
Rate Regulation	)	

OPPOSITION OF NATIONAL CABLE TELEVISION ASSOCIATION, INC.
<u>TO PETITIONS FOR RECONSIDERATION</u>

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Television Association, Inc.

July 21, 1993

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OPPOSITION OF NATIONAL CABLE TELEVISION ASSOCIATION, INC.
TO PETITIONS FOR RECONSIDERATION

The National Cable Television Association, Inc. ("NCTA") hereby opposes the petitions for reconsideration submitted in this proceeding by municipalities and their representatives seeking rule changes that would generally constrain even further the ability of cable operators to charge rates that cover their costs and that enable them to provide the level and quality of service that their customers desire.

INTRODUCTION AND SUMMARY

For reasons described in our own petition for reconsideration, the framework adopted by the Commission to implement the rate regulation provisions of the Cable Television Consumer Protection and Competition Act of 1992 (the "Act") is fundamentally flawed. The root of the problem is the Commission's determination that rates for both basic and non-basic tiers of service are to be subject to the same regulatory standard -- a standard based on the rates that would be charged if a system were subject to "effective competition."

Any effort to ensure that all cable rates are fully "competitive" is sure to encounter problems. Simple "benchmarks" based on rates charged by systems subject to effective competition might at best indicate a range of rates that should be viewed as reasonable and "competitive" but can never accurately reflect the actual costs of any particular system. On the other hand, subjecting every system to comprehensive cost-of-service regulation is inordinately costly, time-consuming and unpredictable and requires a level of expertise and competence that is beyond the ken of most franchising authorities.

The Act, by its terms, requires that basic rates be constrained by regulation to levels charged by comparable systems subject to effective competition. But it contemplates a wholly different standard and regulatory approach for non-basic "cable programming services." Whether rates for those services are "unreasonable" is supposed to depend on how the rates compare not only to the rates of systems subject to effective competition but also to the rates of systems that are not subject to effective competition. And it is also supposed to depend on the system's history of rates -- on whether, for example, rates have increased unreasonably since deregulation.

By opting instead for a unitary benchmark approach -- an approach under which basic and non-basic rates are both subject to the same benchmarks, based on average rates charged by systems subject to effective competition -- the Commission created enormous problems, which are reflected not only by the petitions for reconsideration but also by the Commission's acknowledged practical difficulties in implementing the new rules. Benchmarks based on average rates charged by systems subject to effective competition will, when applied to rates for basic and non-basic tiers, obviously yield rates that are insufficient to cover costs and provide reasonable profits for systems whose costs exceed the average. As the letter submitted to the Commission by 18 lending institutions makes clear, the impact of such an approach on cable systems and on the development of cable television will be substantial.[1]

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[1] See Letter of Bank of America, et al. at 2-3 (June 21, 1993):

> The Cash Flow reductions resulting from the Report and Order threaten to place many cable system operators in default of bank and insurance

The petitions for reconsideration submitted by the cities and municipal organizations are acutely sensitive to the inherent imperfections of benchmarks -- but utterly insensitive to the fundamental problems of the Commission's overall regulatory approach. To the extent that their proposals are aimed at refining the benchmark approach, they all lead to a further lowering of permissible rates -- making the benchmarks and price caps even less viable and requiring even more cable systems to opt for cost-of-service proceedings. And to the extent that they attack the entire benchmark approach, the cities propose that all systems' rates be determined on the basis of cost-of-service ratemaking -- hardly a solution to the already unworkable gridlock that will result from the current approach.

The cities' zeal for constantly lowering rates and their desire not only to regulate rates but also to determine when and whether cable systems may make "prudent" expenditures provide an ominous reminder of why Congress deregulated rates in 1984 -- and why franchising authorities regulatory jurisdiction under the 1992 Act was limited to the basic tier. Preventing the rates of systems not subject to effective competition from exceeding "competitive" levels is a wholly legitimate regulatory objective -- though one that is inherently difficult to achieve with precision. But simply keeping rates low is not a

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company loan agreements since most of these agreements contain financial covenants based on Cash Flow. These financial covenants were based on Cash Flow forecasts prepared prior to the publication of the Report and Order. These forecasts showed reasonable growth in revenues and Cash Flow from a combination of modest rate increases, subscriber growth and system expansion. This forecasted operating performance may in many cases no longer be attainable given the Cash Flow reductions attendant to the FCC benchmark methodology and the disincentives therein to system expansion. Many operators will need to seek amendments of their financial covenants. Others may have to divert funds from capital expenditures, raise additional equity, or amend their debt amortization schedules to meet existing debt repayment obligations. While the strongest cable operators will have financing options, the smaller "all cable" operators will find all forms of capital elusive.

legitimate goal, and capping expenditures in order to do so disserves the public interest. After Congress removed the cities' authority to regulate rates in 1984, rates increased and so did expenditures -- and so did the attractiveness of cable service to consumers, as reflected by rapid increases in penetration rates. Now the cities want to ensure that rates are as low as possible. And they want the right to decide before increased costs are passed through to subscribers, whether those costs are prudent and reasonable. Such a regulatory approach would have prevented the cable industry from making the investments in and improvements to cable service that occurred during the period of deregulation -- just as it stifled cable's development prior to deregulation. Its effects on the ability of the cable industry to meet the telecommunications and video programming needs of the future should be obvious.

For example, the cities generally oppose or seek to limit the ability of cable operators to pass-through any increases in "external" costs without having to justify such increases in comprehensive cost-of-service proceedings -- and in particular, they oppose pass-throughs for expenditures required by the franchising authority. Once a system's "reasonable" rate has been determined, there is no reason not to allow pass-throughs of identifiable cost increases. Such pass-throughs do not provide monopoly profits; they simply allow cable operators to cover the costs of their expenditures. As has historically been the case, the cities fail to acknowledge the link between expenditures necessary to provide better programming and service (or necessary to comply with franchise requirements) and rate increases necessary to pay for such expenditures.

Some cities also argue that they should have the option of requiring cable systems to justify their rates in cost-of-service proceedings even where rates are at or below the applicable benchmarks. While cable operators have a constitutional right to demonstrate that rates higher then the benchmarks are, in particular circumstances, cost-justified -- and while there are sound public policy reasons for providing such a "backstop," given the inherent imprecision of the benchmarks -- there is no comparable requirement or justification for allowing cities to contest rates that are deemed reasonable under the benchmarks. To make rate regulation workable, the Commission needs to fix its benchmarks so that fewer systems need to resort to cost-of-service showings to justify their rates. Abandoning benchmarks and increasing the number of cost-of-service proceedings is precisely the wrong approach.

The cities' proposal that channels carrying certain low-cost services -- e.g., menus and directory services -- not be counted in calculating a system's maximum permissible rate under the benchmarks is similarly wrong-headed. First, it is wrong to discourage the provision of such services; they are useful to subscribers and, in fact, have been provided by systems, even in the absence of rate regulation, for wholly legitimate reasons. Second, if systems are not allowed to recover benchmark rates for channels whose costs are below the benchmark, it obviously will be impossible for them to provide services whose costs are above the benchmark. There is no policy basis for discouraging the provision of services with above-average costs or for requiring systems that want to carry such services to invoke cost-of-service proceedings.

Finally, there is no reason why cable systems should not be allowed to rely on benchmarks for one tier of service and cost-of-service showings for the other. In cost-of-service proceedings, franchising authorities and cities need only ensure that overall rates for regulated services are sufficient to provide a reasonable profit. If a system charges rates no higher than the benchmark for basic service, the Commission can take those rates into account in determining, in a cost-of-service proceeding, whether rates for non-basic service are justified to provide a reasonable profit. Nothing is gained by forcing the system, in such circumstances, also to engage in a second cost-of-service proceeding before the franchising authority.

I. **Pass-Throughs of Increases in Identifiable External Costs Are Wholly Appropriate and Should Be Permitted.**

The parties that, throughout this proceeding, have sought strict regulation of cable rates appear to be largely satisfied with the Commission's benchmarks insofar as they require rather drastic reductions in cable rates. Thus, the National Association of Telecommunications Officers and Advisors, National league of Cities, United States Conference of Mayors, and the National Association of Counties ("Cities") "commend"[2] and "applaud"[3] the Commission's regulatory approach. Indeed, neither the Consumer Federation of America nor the National Association of Broadcasters, each of which submitted substantial comments urging stringent regulation and deep reductions in rates, has petitioned for reconsideration of any aspect of the rules.

Nevertheless, the Cities and some of their member municipalities are concerned that the Commission's decision to allow cable systems to pass through certain "external" costs in future rate increases is too liberal and should be reconsidered. Their concerns are misguided. Once internal rates have been set at levels determined to be reasonable, there is no reason why cable systems should not be allowed to increase their rates to cover increased costs. The purpose of the Act's rate regulation provisions is to limit cable systems' ability to earn excess monopoly profits. Increasing rates to cover identifiable costs does not produce monopoly profits. To require systems whose costs increase at a rate higher than inflation to justify corresponding rate increases in cost-of-service proceedings would be unnecessary and unduly burdensome and would only create the potential for regulatory mischief by franchising authorities. Indeed, NCTA has argued that pass-throughs should be allowed for all identifiable cost increases, including expenditures not only on programming but also on system upgrades and rebuilds.[4]

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2 Cities Petition for Reconsideration at 1.

3 Id. at 2.

4 See NCTA Petition for Reconsideration at 20-22.

Some municipalities oppose allowing pass-throughs for <u>any</u> external costs. According to King County, Washington, <u>et</u> <u>al</u>.,

> The FCC ... assumes, incorrectly, that there is no harm in passing through these external costs, because operators have no power to keep the costs low. Allowing an automatic cost pass through, without even considering whether the cost was prudent, does not create efficiency disincentives, according to the FCC. However, because operators do have significant control over external costs, permitting automatic pass-throughs eliminates incentives to keep those costs down. In fact, operators may decide not to resist paying retransmission fees after October 1994, because at that point, those costs can be added on to rates.[5]

The notion that cable operators, if allowed to pass through increased costs, would have no "incentives to keep those costs down" is plainly wrong. Because cable television is not an essential service and demand for cable service is not completely inelastic, cable operators will never be indifferent to how much they have to pay for programming, equipment or other components of their service. Increasing rates that are already set at "reasonable" levels to cover higher costs is necessary in order to survive, but it will inevitably <u>reduce</u> subscribership; the higher the rate increase, the greater the reduction in subscribership.

In any event, King County, <u>et</u> <u>al</u>. fail to discuss the perverse incentives that would arise if cable operators were <u>not</u> permitted to pass through increases in external costs. If investments would not be available -- unless there were some assurance that they could recoup their investments through higher rates. King County, et al. are right in arguing that disallowing pass-throughs for external costs would keep rates lower. It would, however, do so not by preventing the recovery of monopoly profits but by preventing cable operators from incurring costs necessary to improve the quality of their service.

Unlike King County, et al., the Cities do not generally oppose pass-throughs for external costs -- but they oppose the inclusion, among such costs, of all expenses required by franchising authorities. According to the Cities, only "direct monetary costs specifically enumerated by a stated dollar amount in a franchise agreement to satisfy franchise requirements"[6] should be treated as external costs. Increased expenses incurred to comply with franchise requirements should not, in their view, be allowed to be passed through.

There is absolutely no basis for this distinction. An operator's costs increase -- and corresponding rate increases above the established "reasonable" level are justified -- regardless of whether the city requires direct monetary payments or in-kind expenditures. The various "abuses" that the Cities suggest might occur if all expenditures required by franchising authorities were treated as external costs are illusory and seem to be based on a misunderstanding of the Commission's rules.

For example, the Cities argue that "a cable operator might attempt to pass on as 'indirect' franchise costs the costs it might incur if a franchising authority required it to comply with the FCC's customer service standards."[7] This, they argue, would be "unfair ... given that many cable operators incur these costs already, even in the absence of a franchise provision requiring compliance with the federal standards."[8] But what the rules

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6 Cities Petition at 4.

7 Id. at 5.

8 Id. at 5-6.

permit is the pass-through, in rate increases, of cost increases attributable to franchise requirements. If a system's customer service costs do not increase as a result of a new franchise requirement, then no pass-throughs are justified or permitted. Only those systems for which a new franchise requirement does directly increase costs are entitled to pass-throughs, and only in the amount of the cost increase -- and there is nothing at all "unfair" about allowing such pass-throughs.

Similarly, the Cities argue that

> the Commission's benchmark rates are based on rates charged by cable operators as of September 30, 1992. The only costs the Commission excluded from such rates were franchise fees. Therefore, all other franchise costs, including costs for PEG requirements, are reflected in those benchmark rates. The Commission would be allowing a cable operator to recover such costs twice if the cable operator is able to change the benchmark rate which reflects such costs and to directly pass through such costs to subscribers.[9]

Again, the rules allow a cable operator to pass through increases in external costs, to the extent that they exceed inflation. There is no problem of double recovery. Costs that were already being incurred on September 30, 1992 and are presumably included in the benchmark rate are not to be passed through in subsequent rate increases. Only increases in those costs -- amounts not taken into account when the benchmarks were calculated -- are allowed to be passed through, and there is no reason why such pass-throughs should not be allowed.

Indeed, what is unfair is not that pass-throughs for increases in external costs are allowed. It is that only increases that occur after the basic tier becomes subject to regulation or 180 days after the effective date of the rules can be passed through -- even though initial permissible rates are based on rates charged (and expenses incurred) on

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[9] Id. at 10.

September 30, 1992. In other words, any increases in external costs in excess of inflation that occurred between September 30, 1992 and October 31, 1993 (the earliest date on which a system can become subject to basic rate regulation) can never be passed through in rate increases. Furthermore, even increased programming costs incurred after October 31, 1993 but before October 6, 1994 as a result of retransmission consent can never be passed through in rate increases. And costs attributable to system upgrades and rebuilds are not even treated as external costs; increases in such costs in excess of inflation can never be passed through in rate increases without invoking cost-of-service proceedings.

These are the problems with the Commission's treatment of external costs -- not that identifiable increases in a system's franchise-imposed costs in excess of inflation, can be passed through without invoking cost-of-service proceedings.

II. Cities Should Not Be Permitted to Invoke Cost-of-Service Proceedings.

King County, et al. complain that the Commission "established a one-sided regulatory scheme,"[10] insofar as cable operators are permitted to resort to cost-of-service showings to demonstrate that rates above their applicable benchmarks are justified, but franchising authorities are not permitted to invoke such proceedings to show that, in particular cases, benchmarks are too high. In their view, cost-of-service proceedings ought to be available to the franchising authority or the cable operator to challenge benchmark rates.

Such an approach would, of course, ultimately diminish the use of benchmarks as readily applicable and predictable "safe harbors" for cable operators and subject most operators to the burdens and unpredictability of cost-of-service proceedings -- which is precisely what King County, et al., which believes that "[t]he Commission should move toward a cost-based system of regulation,"[11] would prefer. King County, et al. appear to

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[10] King County, et al. Petition at 1.

[11] Id. at 11.

be the only parties in this proceeding who believe that the Commission should change its rules to encourage more cost-of-service proceedings.

A principal problem with the existing rules is that, because the Commission's benchmarks are based on average rates charged by systems subject to effective competition and are therefore too low to provide reasonable profits to systems with legitimate but above-average costs -- and because the benchmarks are to be applied not only to basic but also to non-basic rates -- there are already likely to be more cost-of-service proceedings than franchising authorities and the Commission can reasonably handle. The delays in resolving these proceedings will create uncertainties that are likely to prevent the industry, as a whole, from investing in new programming and facilities. The appropriate goal for the Commission on reconsideration is to ameliorate this problem by fixing the benchmarks and by recognizing that Congress intended a more flexible approach with respect to non-basic rates -- not to exacerbate the problem by making cost-of-service proceedings the principal mechanism for regulating basic and non-basic rates.

King County, et al. misunderstand the purpose of cost-of-service proceedings in the Commission's regulatory approach, which, as the Commission has recently confined, is to "form a 'backstop' for the benchmark approach to rate regulation."[12] The Commission was rightly "concerned that the benchmark and price cap regulatory framework might not in all cases permit cable operators to recover the reasonable costs of providing regulated cable service,"[13] and it recognized that both as a constitutional matter and as a mater of public policy, its regulatory approach could not force cable operators to change non-remunerative rates. Virtually all parties -- including King County, et al. -- agree that cable operators "must have an opportunity to show that the 'benchmark' results

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[12] Notice of Proposed Rulemaking, MM Docket No. 93-215, ¶ 7 (July 16, 1993)

[13] Id., ¶ 5.

in a rate that is confiscating."[14] But only King County, et al. suggest that franchising authorities are, as a matter of constitutional law, "equally entitled to show that rates are too high based upon cost-of-service."[15]

They find, somewhere in Federal Power Commission v. Hope National Gas Co., 320 U.S. 591 (1944), the notion that a benchmark rate that is higher than might be justified in a cost-of-service proceeding constitutes a "taking" from consumers and is, therefore, unconstitutional. Nothing in that case -- or any other case -- supports such a theory. In Hope, the Court found that the FPC had relied on standards other than those set forth in its enabling statute to approve a rate that could not have been justified under the statutory standards. It found no general constitutional right of consumers to demonstrate, in cost-of-service proceedings, that their rates were too high. Hope is relevant to the present case only insofar as the Commission has ignored its own statutory mandate by applying the same standards and benchmarks to basic and non-basic rates, instead of the different standards required by the Act.

In sum, the Commission is not required to afford franchising authorities and consumers the opportunity to resort to cost-of-service proceedings as a "backstop" whenever they think that benchmark rates are too high. Instead of moving further in the direction of cost-of-service as the principal regulatory mechanism, the Commission should refine and revise its benchmark approach so that it more properly implements the Act's standards and directives.

III. In Determining, for Benchmark Purposes, the Number of Channels on a System, The Commission Should Count All Channels, Regardless of Content.

The Cities and King County, et al. argue that the number of channels on a cable system, for benchmark purposes, should not include channels used for "menu, directory

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[14] [illegible]

and similar services."[16] According to the Cities, "cable operators may suddenly activate unused channels on a cable system, or drop other programming services, in order to include a number of such low cost channels."[17] This, they claim, should be viewed as an "evasion," and operators should be prohibited "from recovering a per channel cost for such channels."[18]

As usual, the Cities are far more concerned that rates be as low as possible than that the quality of cable programming and cable service available to their subscribers be as high as possible. They are acutely sensitive to the incentive that benchmarks create to provide services that cost operators less than they are allowed, on a per-channel basis, to recover. But they show no concern whatever for the corresponding disincentive to carry programming that costs more, on a per-channel basis, than they are allowed to recover. Only by providing some services that cost less than the benchmark rate can operators also provide services that cost more.

Menu and directory services are not sham channels; they provide useful information to subscribers and were typically being carried by systems even when the systems were not subject to rate regulation. If such channels could not be counted in calculating permissible rates, then cable systems simply would be unable to add such services to their array of programming, regardless of their value to consumers. And if operators were effectively precluded from adding channels that cost less than the benchmark, they would certainly be unable to add channels that cost more than they could recover, on a per-channel basis, under the benchmarks.

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16 Cities Petition at 33.

17 Id.

18 Id. See also King County, et al. Petition at 11.

In other words, the Cities' approach would keep rates low by effectively preventing cable operators from adding any new channels. That is precisely the sort of regulatory mindset that controlled not only what subscribes paid but also what they received until 1986. If there are to be benchmarks -- and empirically if the benchmarks are to be as constraining as the existing ones -- the Commission simply cannot further intrude on program selection by deciding, on the basis of a channel's content or its cost, that certain channels will not be counted in the calculation of benchmark rates.

IV. There Is No Reason Why Cable Systems Should Not Be Allowed to Opt for Benchmarks on One Tier and Cost-of-Service Proceedings on the Other.

The Cities argue that the Commission should change its rules to require that a cable operator make a single election between benchmarks and cost-of-service showings and that, "whatever method it chooses, [it] should be forced to make the same submission in both the basic and cable programming service tier rate proceedings if both proceedings occur within a reasonable time of each other."[19] According to the Cities, such a rule change would "ensure that the 'reasonable' rate established for each tier is consistent."[20] Allowing cable operators to opt for benchmarks on one tier and cost-of-service on the other would, they claim, "undermine the Commission's intention that the same 'reasonable' rate determination be made on both basic and cable programming service tiers."[21]

But there is no evidence of any such overriding intention on the Commission's part, and in fact, the rules would not generally ensure a uniform rate on both tiers even if the proposed change were adopted. The Commission did, indeed, rule that the same per-channel benchmark should apply to both basic and non-basic tiers in order to ensure that

[19] Cities Petition at 38.

[20] Id.

[21] Id. at 39.

the benchmarks were "tier-neutral" and did not themselves create "incentives that could reduce the number of services on the basic tier."[22] But its regulatory framework nowhere mandates that, to be "reasonable", the per-channel rates for both tiers must be identical.

For example, a system whose rate for any tier on the initial date of regulation is below the benchmark is not permitted to raise its rate to the benchmark level, even though rates for other tiers that are above the benchmark on the initial date of regulation may be reduced to no less than the benchmark level. Obviously, in these circumstances, the Commission has no "intention that the same 'reasonable' rate determination be made on both basic and cable programming service tiers."[23]

Moreover, even if a system opted to make cost-of-service showings with respect to both its basic and non-basic tiers, nothing in the rules guarantees or requires that the franchising authority and the Commission make identical findings with respect to each tier of service. If such uniformity were required, there would be no reason to authorize franchising authorities to review and rule upon cost-of-service showings even with respect to basic rates. If the Commission's cost-of-service determinations are to be dispositive with respect to basic and non-basic tiers, then the Commission should be authorized to conduct a single cost-of-service proceeding.

Indeed, where a cable system opts to justify both basic and non-basic rates on the basis of cost-of-service showings, it makes sense for the Commission to conduct a single proceeding. In that circumstance, a single proceeding aimed at ensuring that the overall rates charged by the operator are reasonable is more efficient and rational then two independent proceedings -- especially since the Commission would, in any event, have authority to review the separate decision of the franchising authority. But where a system opts to justify one tier's rate on the basis of benchmarks, there is no reason why the

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22 Report and Order, ¶ 197.

23 Cities Petition at 35.

reasonableness of rates for the other tier cannot be considered in a cost-of-service proceeding. In that proceeding, either the franchising authority or the Commisison could determine whether the rates charged for the tier in question are reasonable and necessary to allow the system a reasonable profit in light of the system's costs and in light of the rates charged by the system, pursuant to the benchmark, for the other tier.

CONCLUSION

For the foregoing reasons, the Commission should decline to adopt the rule changes proposed by the municipalities and their representatives -- changes that would only restrict further the ability of cable operators to price, package, develop and offer services in a manner that best meets the needs and demands of their subscribers.

Respectfully submitted,

NATIONAL CABLE TELEVISION
ASSOCIATION, INC.

By /s/ Daniel L. Brenner
Daniel L. Brenner

By /s/Michael S. Schooler
Michael S. Schooler

ITS ATTORNEYS
1724 Massachusetts Avenue, NW
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July 21, 1993

CERTIFICATE OF SERVICE

I, Leslie D. Heath, do hereby certify that on this 21st day of July, 1993, true copies of the foregoing "Opposition of National Cable Television Association, Inc. to Petitions for Reconsideration" were delivered by first-class postage pre-paid United States mail to the following parties.

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